BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers	CC Docket No. 98-166

REPLY COMMENTS of the GENERAL SERVICES ADMINISTRATION

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March 16, 1999

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The General Services Administration ("GSA") submits these Reply Comments on behalf of the customer interests of all Federal Executive Agencies ("FEAs") in response to the Commission's Notice of Proposed Rulemaking ("NPRM") released on October 5, 1998. In the NPRM, the Commission seeks comments on whether the low-end adjustment threshold should be revised in this proceeding

I. INTRODUCTION

On January 19, 1999, GSA filed Comments in this proceeding endorsing the Commissioner's proposal to set the low-end formula adjustment mechanism ("LFAM") threshold at 100 basis points below the rate of return prescribed in this proceeding. GSA noted that a failure to adjust the LFAM threshold when the local exchange carrier ("LEC") cost of capital changes would break this link to just and reasonable rates.[1]

Comments on this issue were also filed by:

- The Local Exchange Carrier Associations ("LEC Associations") and four individual LECs;
- AT&T Corp. ("AT&T"); and
- MCI WorldCom, Inc. ("MCI WorldCom").

In these Reply Comments, GSA responds to the proposals and comments of these parties.

II. THE LFAM SHOULD BE RETAINED AND SHARING REINSTATED

Both AT&T and MCI WorldCom argue that the LFAM should be eliminated given the elimination of the price cap sharing mechanism.[2] MCI WorldCom notes that "[t]he lower formula adjustment mark was put in place to provide the price cap LECs with a protection from low earnings that was symmetric with their ability to achieve higher earnings."[3] The LEC Associations and individual LECs do not comment on this lack of symmetrical treatment for low and high earnings.

To rectify this situation, AT&T urges the Commission to either eliminate the LFAM or reevaluate its decision to remove the sharing obligations imposed on LECs earning at rate-of-return levels that are too high.[4] MCI WorldCom recommends that the Commission either eliminate the LFAM or revise it to ensure that the LECs are guaranteed to earn only

[1] Comments of the GSA, p.4.

[2] Comments of AT&T, pp. 2-6; MCI WorldCom, pp.4-5.

[3] Comments of MCI WorldCom, p.7.

[4] Comments of AT&T, p.5.

the unitary rate of return over time.[5]

GSA agrees with AT&T and MCI WorldCom that the existing "lopsided" regulatory scheme is untenable and should not be continued. The easy way to deal with the current asymmetry would be to simply eliminate the LFAM. In this case, however, the easy way is contrary to the public interest.

Until effective and persuasive local exchange and exchange access competition strips the incumbent LECs of their market power, the Commission must protect the public's right to just and reasonable telephone rates. As long as LEC prices are regulated by the Commission, moreover, the Commission must provide the LECs with the opportunity to earn a fair return on the capital it invests to serve the public.

The Commission's original price cap plan recognized this need to provide a "proper balance of incentives and safeguards" by incorporating a sharing of high earnings and a LFAM to protect the LECs from unfairly low earnings.[6] In its Reconsideration Order, the Commission stated:

> The plan gives LECs flexibility and the right to retain more of their earnings; it balances these opportunities against the possibility that LECs might earn less if they fail to respond to the incentives provided. LECs are reasonably expected to become more efficient in order to earn higher profits, or even to maintain their current profits. Both ends of the scale are necessary to the validation of the incentives.[7]

[5] Comments of MCI WorldCom, p.6.

[6] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No.87-313, Second Report and Order, FCC 90-314, released October 4, 1990 ("Second Price Cap Order"), para.164-5.

[7] Id., Order on Reconsideration, FCC 91-115 released April 17, 1991 ("Reconsideration Order"), para. 117.

Unfortunately, in its Fourth Price Cap Order, the Commission upset the symmetry of its price cap plan by eliminating the sharing requirement despite the protests of users such as GSA.[8] The elimination of sharing was wrong, because it allows the LECs to retain all of the excess revenues resulting from the adoption of inadequate productivity adjustments. In 1997, the average rate of return of price cap carriers was 15.64 percent, far above the currently authorized rate of return of 11.25 percent.[9] Moreover, as GSA demonstrated in its Direct Case, the current LEC rate of return should be only 9.5 percent.[10] The Regional Bell Operating Companies alone retained over $2 billion more in revenues than necessary to earn this return in 1997.[11]

On the other hand, the elimination of the LFAM would also be wrong, because it would deprive the LECs of a safety-net to ensure that they are not required to charge unreasonably low rates. Two wrongs will not make a right. The Commission should retain the LFAM and reinstate the earnings sharing mechanism.

III. THE LFAM THRESHOLD SHOULD BE SET AT LEAST 100 BASIS POINTS BELOW THE RATE OF RETURN PRESCRIBED IN THIS PROCEEDING

MCI WorldCom recommends that, if the LFAM is retained, the threshold be set

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[8] See, e.g., Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Comments of GSA, December 18, 1995, pp.7-8; Reply Comments of GSA, March 1, 1996, pp.10-11; Comments of GSA, January 29, 1997, p.19; Reply Comments of GSA, February 14, 1997.

[9] Trends in Telephone Service, July 1998, Table 14.1.

[10] Direct Case of GSA, p. 23.

[11] See Attachment 1 to these Reply Comments.

based on the amount of historically achieved earnings above the unitary rate of return.[12] Based on an 11.25 percent cost of capital, this would result in an LFAM of 3.12 percent.[13] Based on a 9.5 percent rate of return, this would result in an LFAM of -2.13 percent.[14] The LEC Associations and individual LECs oppose any reduction in the LFAM below its current level of 10.25 percent.[15] They argue that the risks of price cap carriers have increased and that the LFAM should be determined independently and delinked from the authorized rate of return.[16]

As discussed above, GSA urges the Commission to reinstate sharing and a balanced mechanism of risks and rewards. The newly prescribed rate of return should represent the center of a "no-action" zone. LEC earnings in this zone would result in neither an LFAM increase in rates nor a sharing-based decrease in rates. LEC earnings below this zone would allow the LEC a rate increase which would bring its earnings to the threshold. LEC earnings above this zone would require a rate decrease to share the excess with interstate ratepayers.

The original price cap plan set this zone at 100 basis points above and below the unitary rate of return. Since the LECs have demonstrated their ability to earn several hundred basis points above their cost of capital, 100 basis point would appear ro represent

[12] Comments of MCI WorldCom, pp.5-7.

[13] Id., p.7.

[14] Id., footnote 12.

[15] See, e.g. Comments of LEC Associations, pp.14-15; SBC Communications Inc. ("SBC"), pp. 5-7; GTE, pp. 7-8.

[16] Id.

a minimum reasonable boundary to the "no action" zone.[17] On the other hand, an LFAM threshold below the marginal cost of debt might impair a LEC's ability to raise the capital needed to serve interstate ratepayers.

GSA recommends, therefore, that the Commission set the LFAM threshold at least 100 basis points below the new unitary rate of return, but no lower than the marginal cost of debt.

[17] In 1997, for example, Ameritech and BellSouth reported returns which were more than 600 basis points above the authorized 11.25 percent return.

VI. CONCLUSION

As a major user of telecommunications services, GSA urges the Commission to set the low-end adjustment threshold at least 100 basis points below the rate of return prescribed in this proceeding, but no lower than the marginal cost of debt.

Respectfully submitted,

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1997 RBOC Excess Revenues

($000)

RBOC	Rate Base	ROR	Excess Earnings	Excess Revenues
a	**b**	**c**	**d = b (c - 9.5)**	**e = d / .66**
Ameritech	$ 2,874,445	18.22%	$ 250,652	$ 379,775
Bell Atlantic	4,321,192	14.77%	227,727	345,041
Bell Atlantic (NYNEX)	3,742,254	13.73%	158,297	239,844
BellSouth	4,761,659	17.90%	399,979	606,029
Southwestern Bell	3,460,963	10.32%	28,380	43,000
Nevada Bell	75,359	19.46%	7,506	11,372
Pacific Bell	2,788,599	11.90%	66,926	101,404
U S West	3,865,936	15.39%	227,704	345,006
Total				**$ 2,071,471**

Sources: Col. b = ARMIS 43-01 Reports
Col. c = Trends in Telephone Service, July 1998, Table 14.1

CERTIFICATE OF SERVICE

I, MICHAEL J. ETTNER, do hereby certify that copies of the foregoing "Reply Comments of the General Services Administration" were served this 16th day of March, 1999, by hand delivery or postage paid to the following parties:

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